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FINANCIAL ACCOUNTING 3e

IFRS EDITION

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PREVIEW OF CHAPTER 1

ACCOUNTING IN ACTION

What Is Accounting?
- Three activities
- Who uses accounting data?

The Building Blocks of Accounting
- Ethics in financial reporting
- Accounting standards
- Measurement principles
- Assumptions

The Basic Accounting Equation
- Assets
- Liabilities
- Equity

Using the Accounting Equation
- Transaction analysis
- Summary of transactions

Financial Statements
- Income statement
- Retained earnings statement
- Statement of financial position
- Statement of cash flows
- Comprehensive income statement

CHAPTER

1 Accounting in Action

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Explain what accounting is.
2. Identify the users and uses of accounting.
3. Understand why ethics is a fundamental business concept.
4. Explain accounting standards and measurement principles.
5. Explain the monetary unit assumption and the economic entity assumption.
6. State the accounting equation, and define its components.
7. Analyze the effects of business transactions on the accounting equation.
8. Understand the five financial statements and how they are prepared.

What is Accounting?

Learning Objective 1
Explain what accounting is.

Accounting consists of three basic activities—it

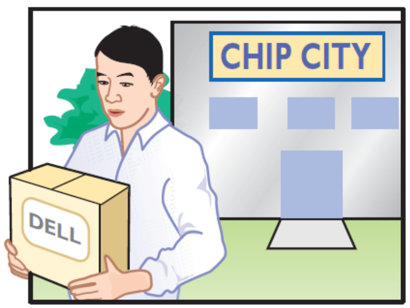
- **identifies**,
- **records**, and
- **communicates**

the economic events of an organization to interested users.

Three Activities

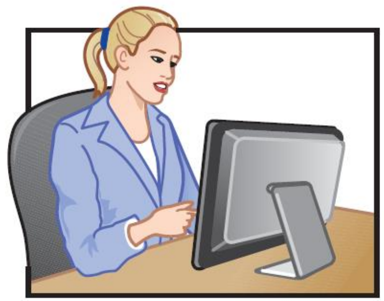
Illustration 1-1
The activities of the accounting process

Identification



Select economic events (transactions)

Recording



Record, classify, and summarize

Communication

Prepare accounting reports

Analyze and interpret for users

The accounting process includes the **bookkeeping** function.

Assumptions

Review Question

Which of the following is **not** a step in the accounting process?

a. Identification.

b. Recording.

c. Economic entity.

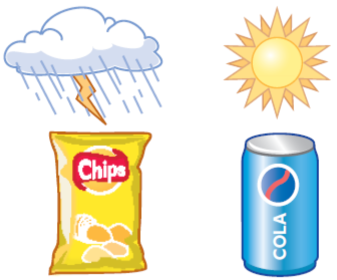
d. Communication

Who Uses Accounting Data?

INTERNAL USERS

Marketing

What price for a Nokia cell phone will maximize the company's net income?

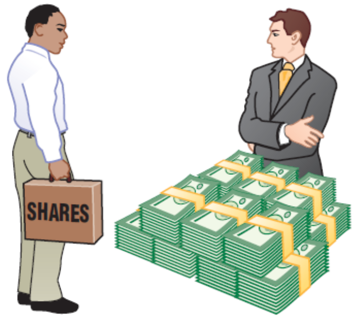


Snack chips

Beverages

Management

Which PepsiCo product line is the most profitable? Should any product lines be eliminated?



Finance

Is cash sufficient to pay dividends to SAP shareholders?

Human Resources

Can we afford to give Toyota employees pay raises this year?

Illustration 1-2
Questions that internal users ask

Who Uses Accounting Data?

Learning Objective 2
Identify the users and uses of accounting.

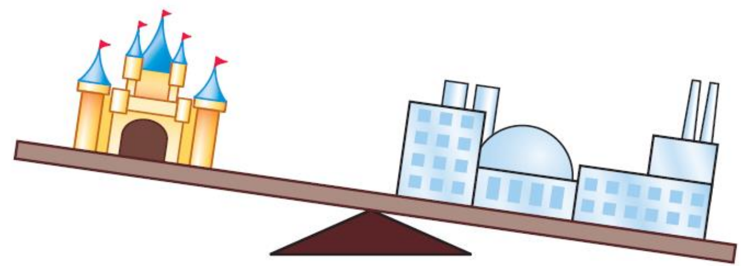
EXTERNAL USERS

Investors

Is Royal Dutch Shell earning satisfactory income?

Creditors

Will Singapore Airlines be able to pay its debts as they come due?



Investors

How does Disney compare in size and profitability with Time Warner?

Illustration 1-3
Questions that external users ask

> DO IT!

Indicate whether the following statements are **true or false**.

1. The three steps in the accounting process are identification, recording, and communication.
2. Bookkeeping encompasses all steps in the accounting process.
3. Accountants prepare, but do not interpret, financial reports.
4. The two most common types of external users are investors and company officers.
5. Managerial accounting activities focus on reports for internal users.

Solution: 1. True 2. False 3. False 4. False 5. True

Ethics in Financial Reporting

Standards of conduct by which one's actions are judged as right or wrong, honest or dishonest, fair or not fair, are **ethics**.

Learning Objective 3
Understand why ethics is a fundamental business concept.

- Recent financial scandals include: **Enron** (USA), **Parmalat** (ITA), **Satyam Computer Services** (IND), **AIG** (USA), and others.
- Effective financial reporting depends on sound ethical behavior.

Ethics in Financial Reporting

1. Recognize an ethical situation and the ethical issues involved.

Use your personal ethics to identify ethical situations and issues. Some businesses and professional organizations provide written codes of ethics for guidance in some business situations.

2. Identify and analyze the principal elements in the situation.

Identify the **stakeholders**—persons or groups who may be harmed or benefited. Ask the question: What are the responsibilities and obligations of the parties involved?

3. Identify the alternatives, and weigh the impact of each alternative on various stakeholders.

Select the most ethical alternative, considering all the consequences. Sometimes there will be one right answer. Other situations involve more than one right solution; these situations require an evaluation of each and a selection of the best alternative.

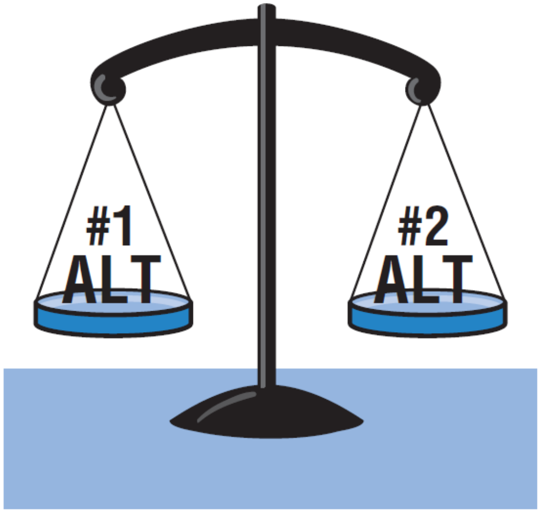


Illustration 1-4
Steps in analyzing ethics cases and situations

Accounting Standards

International Accounting Standards Board (IASB) http://www.iasb.org/

International Financial Reporting Standards

Financial Accounting Standards Board (FASB) http://www.fasb.org/

Generally Accepted Accounting Principles (GAAP)

Learning Objective 4

Explain accounting standards and the measurement principles.

Measurement Principles

HISTORICAL COST PRINCIPLE (or cost principle) dictates that companies record assets at their cost.

FAIR VALUE PRINCIPLE states that assets and liabilities should be reported at fair value (the price received to sell an asset or settle a liability).

> **Helpful Hint**
> *Relevance* and *faithful representation* are two primary qualities that make accounting information useful for decision-making.

Assumptions

Learning Objective 5
Explain the monetary unit assumption and the economic entity assumption.

MONETARY UNIT ASSUMPTION requires that companies include in the accounting records only transaction data that can be expressed in terms of money.

ECONOMIC ENTITY ASSUMPTION requires that activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities.

- **Proprietorship**
- **Partnership**
- **Corporation**

Forms of Business Ownership

Forms of Business Ownership

Proprietorship

- Owned by one person
- Owner is often manager/operator
- Owner receives any profits, suffers any losses, and is personally liable for all debts

Partnership

- Owned by two or more persons
- Often retail and service-type businesses
- Generally unlimited personal liability
- Partnership agreement

Corporation

- Ownership divided into shares
- Separate legal entity organized under corporation law
- Limited liability

Assumptions

Review Question

The historical cost principle states that:

a. assets should be initially recorded at cost and adjusted when the fair value changes.

b. activities of an entity are to be kept separate and distinct from its owner.

c. assets should be recorded at their cost.

d. only transaction data capable of being expressed in terms of money be included in the accounting records.

> DO IT!

Indicate whether each of the following statements presented below is true or false.

1. Convergence refers to efforts to reduce differences between IFRS and U.S. GAAP.

   True

2. The primary accounting standard-setting body headquartered in London is the International Accounting Standards Board (IASB).

   True

3. The historical cost principle dictates that companies record assets at their cost. In later periods, however, the fair value of the asset must be used if fair value is higher than its cost.

   False

> DO IT!

Indicate whether each of the following statements presented below is true or false.

4. Relevance means that financial information matches what really happened; the information is factual.

False

5. A business owner's personal expenses must be separated from expenses of the business to comply with accounting's economic entity assumption.

True

The Basic Accounting Equation

Learning Objective 6
State the accounting equation, and define its components.

Basic Accounting Equation

- Provides the **underlying framework** for recording and summarizing economic events.
- Assets **must** equal the sum of liabilities and equity.

Assets = **Liabilities** + **Equity**

Basic Accounting Equation

Assets	=	Liabilities	+	Equity

Assets

- Resources a business owns.
- Provide future services or benefits.
- Cash, Inventory, Equipment, etc.

Basic Accounting Equation

Assets	=	Liabilities	+	Equity

Liabilities

- Claims against assets (debts and obligations).
- Creditors (party to whom money is owed).
- Accounts Payable, Notes Payable, Salaries and Wages Payable, etc.

Basic Accounting Equation

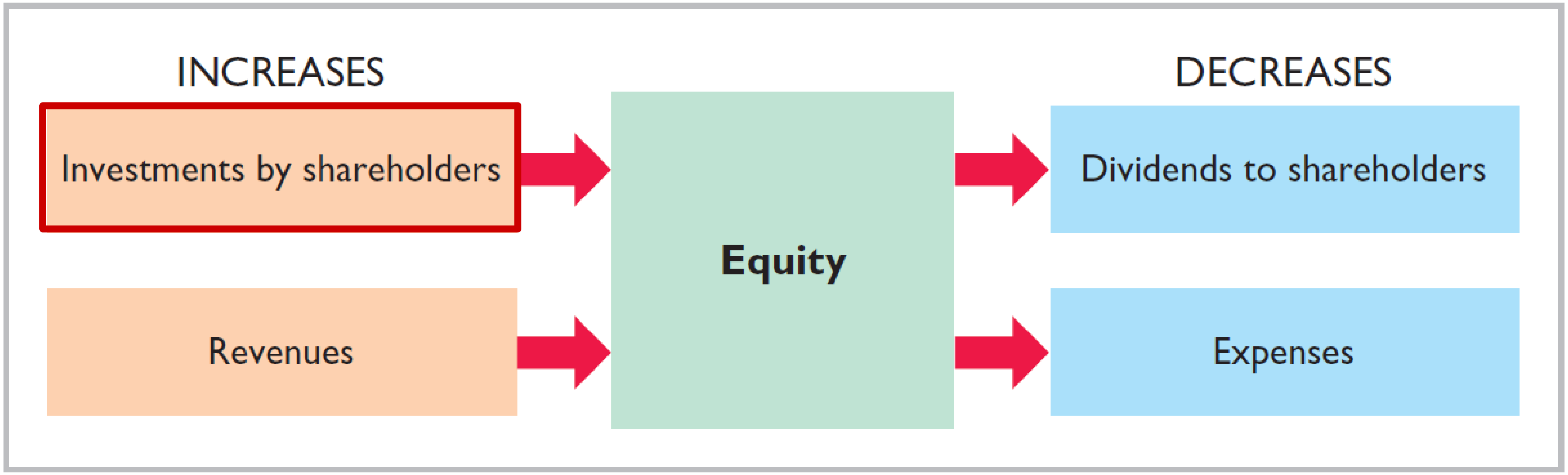
Assets = **Liabilities** + **Equity**

Equity

- Ownership claim on total assets.
- Referred to as residual equity.
- **Share Capital—Ordinary** and **Retained Earnings**.

Equity

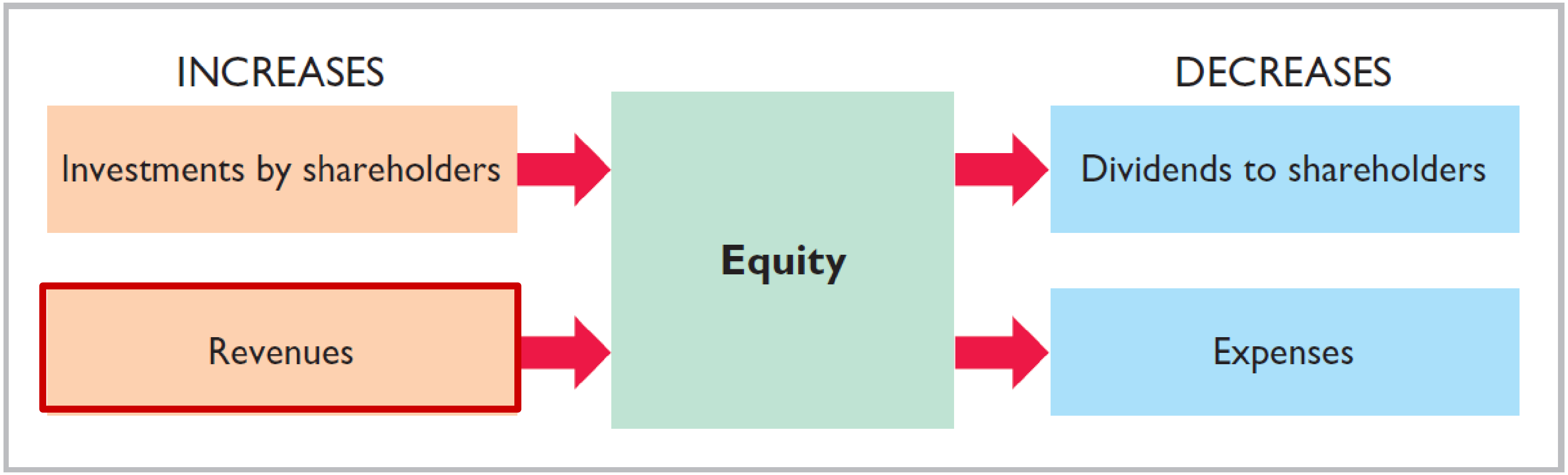
Illustration 1-7
Increases and decreases in equity



Investments by shareholders represent the total amount paid in by shareholders for the ordinary shares they purchase.

Stockholders' Equity

Illustration 1-7
Increases and decreases in equity

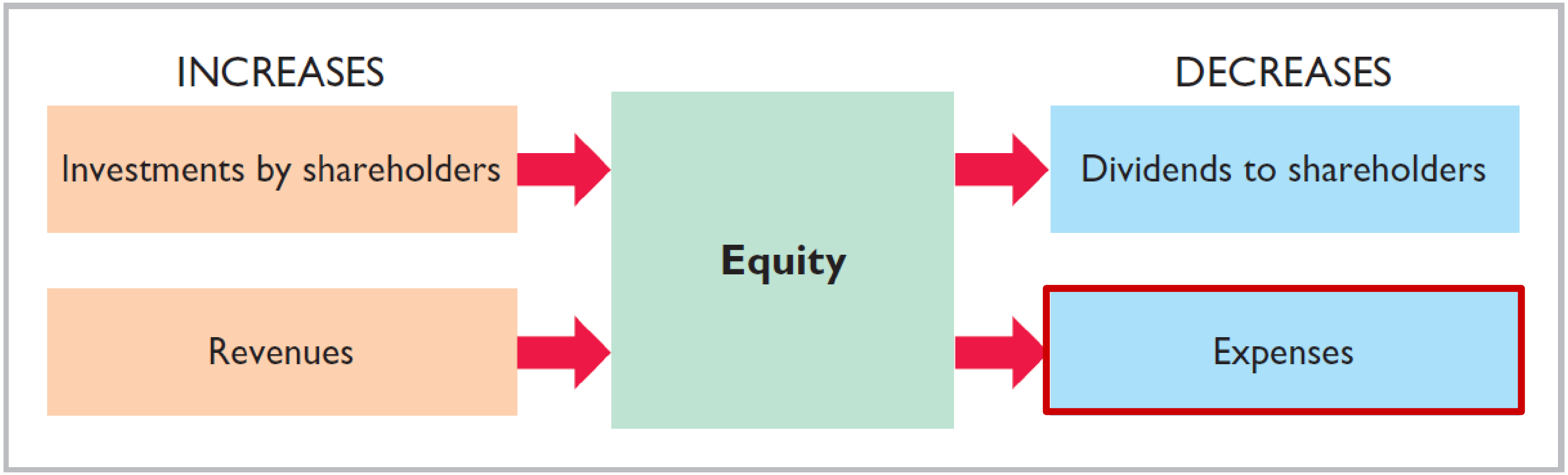


Revenues result from business activities entered into for the purpose of earning income.

Common sources of revenue are: sales, fees, services, commissions, interest, dividends, royalties, and rent.

Stockholders' Equity

Illustration 1-7
Increases and decreases in equity

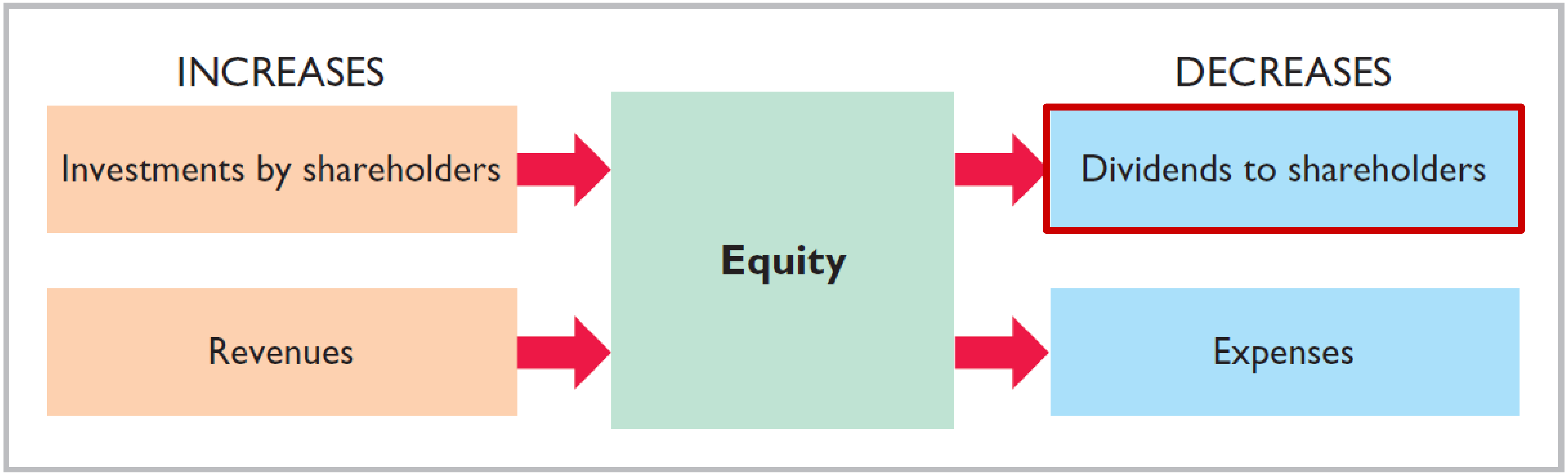


Expenses are the cost of assets consumed or services used in the process of earning revenue.

Common expenses are: salaries expense, rent expense, utilities expense, property tax expense, etc.

Stockholders’ Equity

Illustration 1-7
Increases and decreases in equity



Dividends are the distribution of cash or other assets to shareholders.

Dividends reduce retained earnings. However, dividends are **not expenses**.

LO 6

> DO IT!

Classify the following items as issuance of stock, dividends, revenues, or expenses. Then indicate whether each item increases or decreases stockholders' equity.

	Classification	Effect on Equity
1. Rent Expense		
2. Service Revenue		
3. Dividends		
4. Salaries and Wages Expense		

LO 6

The Basic Accounting Equation

Transactions are a business's economic events recorded by accountants.

- May be **external** or **internal**.
- Not all activities represent transactions.
- Each transaction has a dual effect on the accounting equation.

Learning Objective 7 *Analyze the effects of business transactions on the accounting equation.*

LO 7

Transaction Analysis

Illustration: Are the following events recorded in the accounting records?

Event	Purchase computer	Discuss product design with potential customer	Pay rent
Criterion	Is the financial position (assets, liabilities, or stockholder's equity) of the company changed?		
Record/ Don't Record	Yes	No	Yes

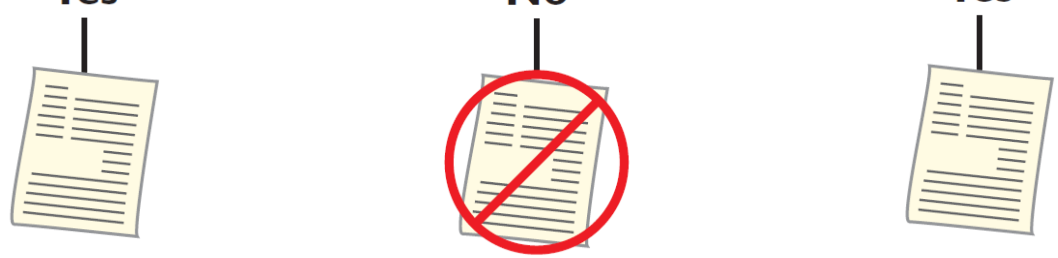


Illustration 1-8
Transaction-identification process

LO 7

Transaction Analysis

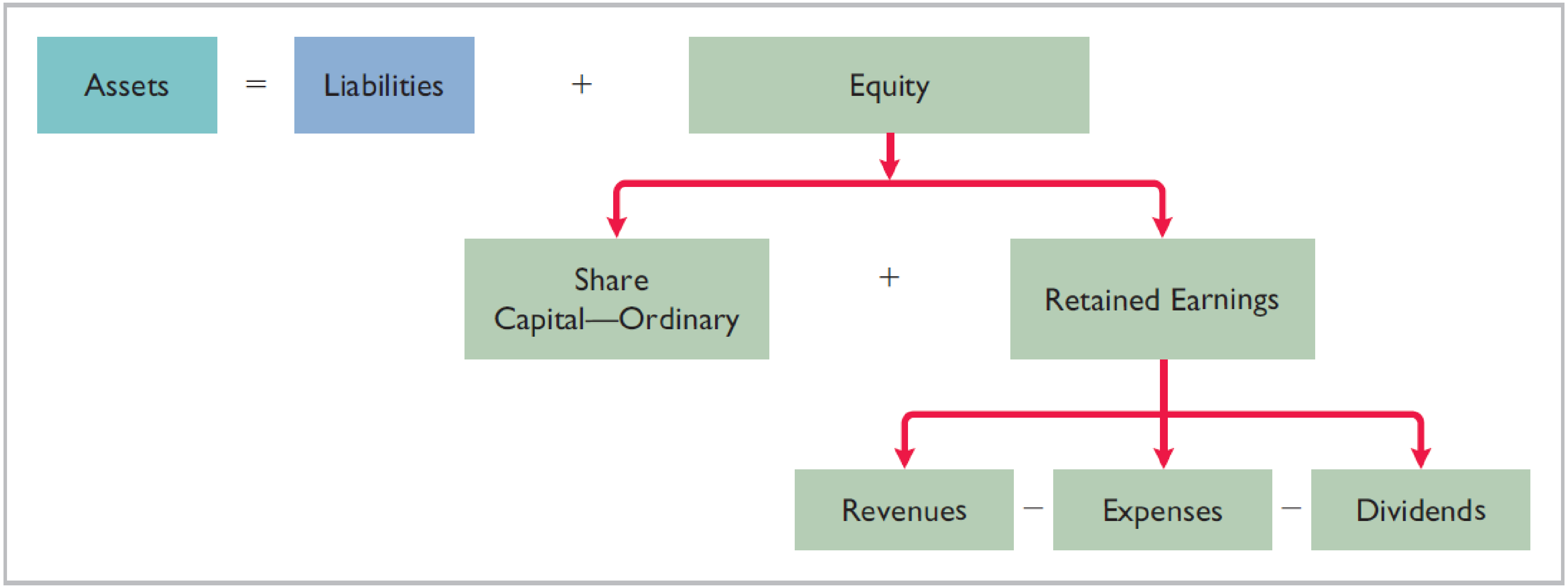


Illustration 1-9
Expanded accounting equation

Transaction Analysis

TRANSACTION 1. INVESTMENT BY STOCKHOLDERS Ray and Barbara Neal decide to start a smartphone app development company that they incorporate as Softbyte SA. On September 1, 2017, they invest **€15,000 cash** in the business in exchange for **€15,000 of ordinary shares**. The ordinary shares indicates the ownership interest that the Neals have in Softbyte SA. This transaction results in an equal increase in both assets and equity.

Illustration 1-10

	Assets							= Liabilities +				Equity				
Trans-action	**Cash**	**+**	**Accounts Receivable**	**+**	**Supplies**	**+**	**Equipment**	**=**	**Accounts Payable**	**+**	**Share Capital**	**+**	**Retained Earnings Rev.**	**–**	**Exp.**	**–**	**Div.**
1.	+15,000										+15,000						

TRANSACTION 2. PURCHASE OF EQUIPMENT FOR CASH Softbyte SA purchases computer equipment for **€7,000 cash**.

Illustration 1-10

	Assets				= Liabilities +	Equity			
Transaction	Cash +	Accounts Receivable +	Supplies +	Equipment =	Accounts Payable +	Share Capital +	Retained Earnings Rev. –	Exp. –	Div.
1.	+15,000					+15,000			
2.	-7,000			+7,000					

TRANSACTION 3. PURCHASE OF SUPPLIES ON CREDIT Softbyte SA **purchases for €1,600** headsets and other accessories expected to last several months. The supplier allows Softbyte to pay this bill in October.

Illustration 1-10

	Assets				= Liabilities +	Equity			
Trans-action	Cash +	Accounts Receivable +	Supplies +	Equipment =	Accounts Payable +	Share Capital +	Retained Earnings Rev. –	Exp. –	Div.
1.	+15,000					+15,000			
2.	-7,000			+7,000					
3.			+1,600		+1,600				

TRANSACTION 4. SERVICES PERFORMED FOR CASH Softbyte SA receives **€1,200 cash** from customers for app development services it has performed.

Illustration 1-10

	Assets				= Liabilities +	Equity			
Trans-action	Cash +	Accounts Receivable +	Supplies +	Equipment =	Accounts Payable +	Share Capital +	Retained Earnings Rev. –	Exp. –	Div.
1.	+15,000					+15,000			
2.	-7,000			+7,000					
3.			+1,600		+1,600				
4.	+1,200						+1,200		

TRANSACTION 5. PURCHASE OF ADVERTISING ON CREDIT Softbyte SA receives a **bill for €250** from the *Programming News* for advertising on its website but postpones payment until a later date.

Illustration 1-10

	Assets				= Liabilities +	Equity			
							Retained Earnings		
Trans-action	Cash +	Accounts Receivable +	Supplies +	Equipment =	Accounts Payable +	Share Capital +	Rev. –	Exp. –	Div.
1.	+15,000					+15,000			
2.	-7,000			+7,000					
3.			+1,600		+1,600				
4.	+1,200						+1,200		
5.					+250			-250	

TRANSACTION 6. SERVICES PROVIDED FOR CASH AND CREDIT. Softbyte provides **€3,500 of services**. The company receives **cash of €1,500** from customers, and it bills the balance of **€2,000 on account**.

Illustration 1-10

	Assets				= Liabilities +		Equity		
							Retained Earnings		
Trans-action	Cash +	Accounts Receivable +	Supplies +	Equipment =	Accounts Payable +	Share Capital +	Rev. –	Exp. –	Div.
1.	+15,000					+15,000			
2.	-7,000			+7,000					
3.			+1,600		+1,600				
4.	+1,200						+1,200		
5.					+250			-250	
6.	+1,500	+2,000					+3,500		

TRANSACTION 7. PAYMENT OF EXPENSES Softbyte SA pays the following expenses in cash for September: office rent **€600**, salaries and wages of employees **€900**, and utilities **€200**.

Illustration 1-10

	Assets				= Liabilities +	Equity			
Trans-action	Cash	+ Accounts Receivable	+ Supplies	+ Equipment =	Accounts Payable	+ Share Capital	+ Retained Earnings Rev.	– Exp.	– Div.
1.	+15,000					+15,000			
2.	-7,000			+7,000					
3.			+1,600		+1,600				
4.	+1,200						+1,200		
5.					+250			-250	
6.	+1,500	+2,000					+3,500		
7.	-1,700							-600 -900 -200	

TRANSACTION 8. PAYMENT OF ACCOUNTS PAYABLE Softbyte SA **pays its €250** *Programming News* bill in cash. The company previously (in Transaction 5) recorded the bill as an increase in Accounts Payable.

Illustration 1-10

	Assets				= Liabilities +	Equity			
Trans-action	Cash +	Accounts Receivable +	Supplies +	Equipment =	Accounts Payable +	Share Capital +	Retained Earnings Rev. –	Exp. –	Div.
1.	+15,000					+15,000			
2.	-7,000			+7,000					
3.			+1,600		+1,600				
4.	+1,200						+1,200		
5.					+250			-250	
6.	+1,500	+2,000					+3,500		
7.	-1,700							-600 -900 -200	
8.	-250				-250				

TRANSACTION 9. RECEIPT OF CASH ON ACCOUNT Softbyte SA **receives €600 in cash** from customers who had been billed for services (in Transaction 6).

Illustration 1-10

	Assets				= Liabilities +	Equity			
Trans-action	Cash +	Accounts Receivable +	Supplies +	Equipment =	Accounts Payable +	Share Capital +	Retained Earnings Rev. –	Exp. –	Div.
1.	+15,000					+15,000			
2.	-7,000			+7,000					
3.			+1,600		+1,600				
4.	+1,200						+1,200		
5.					+250			-250	
6.	+1,500	+2,000					+3,500		
7.	-1,700							-600 -900 -200	
8.	-250				-250				
9.	+600	-600							

TRANSACTION 10. DIVIDENDS The corporation pays a dividend of **€1,300 in cash** to Ray and Barbara Neal, the shareholders of Softbyte SA.

Illustration 1-10

	Assets				= Liabilities +	Equity			
							Retained Earnings		
Trans-action	Cash +	Accounts Receivable +	Supplies +	Equipment =	Accounts Payable +	Share Capital +	Rev. –	Exp. –	Div.
1.	+15,000					+15,000			
2.	-7,000			+7,000					
3.			+1,600		+1,600				
4.	+1,200						+1,200		
5.					+250			-250	
6.	+1,500	+2,000					+3,500		
7.	-1,700							-600 -900 -200	
8.	-250				-250				
9.	+600	-600							
10.	-1,300								-1,300

€18,050 €18,050

Summary of Transactions

1. Each transaction must be analyzed in terms of its effect on:
   a. The three components of the basic accounting equation.
   b. Specific types (kinds) of items within each component.
2. The two sides of the equation must always be equal.
3. The Share Capital—Ordinary and Retained Earnings columns indicate the causes of each change in the shareholders' claim on assets.

> DO IT!

Transactions made by Virmari & Co. SA, a public accounting firm, for the month of August are shown below. Prepare a tabular analysis which shows the effects of these transactions on the expanded accounting equation, similar to that shown in Illustration 1-10.

1. The company issued ordinary shares for €25,000 cash.
2. The company purchased €7,000 of office equipment on credit.
3. The company received €8,000 cash in exchange for services performed.
4. The company paid €850 for this month's rent.
5. The company paid a dividend of €1,000 in cash to shareholders.

> DO IT!

1. The company issued ordinary shares for €25,000 cash.

	Assets			=	Liabilities +		Equity						
Trans-action	Cash	+	Equipment	=	Accounts Payable	+	Share Capital	+	Retained Earnings Rev.	–	Exp.	–	Div.
1.	+25,000						+25,000						

> DO IT!

2. The company purchased €7,000 of office equipment on credit.

	Assets		=	Liabilities +	Equity			
Trans-action	Cash	+ Equipment	=	Accounts Payable	+ Share Capital	+ Retained Earnings Rev.	– Exp.	– Div.
1.	+25,000				+25,000			
2.		+7,000		+7,000				

> **DO IT!**

3. **The company received €8,000 cash in exchange for services performed.**

	Assets		= Liabilities +	Equity			
					Retained Earnings		
Trans-action	Cash +	Equipment =	Accounts Payable +	Share Capital +	Rev. –	Exp. –	Div.
1.	+25,000			+25,000			
2.		+7,000	+7,000				
3.	+8,000				+8,000		

> DO IT!

4. The company paid €850 for this month's rent.

	Assets		=	Liabilities +	Equity			
						Retained Earnings		
Trans-action	Cash +	Equipment	=	Accounts Payable +	Share Capital +	Rev. –	Exp. –	Div.
1.	+25,000				+25,000			
2.		+7,000		+7,000				
3.	+8,000					+8,000		
4.	-850						-850	

> DO IT!

5. The company paid a dividend of €1,000 in cash to shareholders.

	Assets			=	Liabilities +		Equity						
Trans-action	Cash	+	Equipment	=	Accounts Payable	+	Share Capital	+	Retained Earnings Rev.	–	Exp.	–	Div.
1.	+25,000						+25,000						
2.			+7,000		+7,000								
3.	+8,000								+8,000				
4.	-850										-850		
5.	-1,000												-1,000
	€31,150	+	€7,000	=	€7,000	+	€25,000	+	€8,000	-	€850	-	€1,000

€38,150 €38,150

LO 7

The Basic Accounting Equation

Learning Objective 8
Understand the five financial statements and how they are prepared.

Companies prepare five financial statements :

- **Income Statement**
- **Retained Earnings Statement**
- **Statement of Financial Position**
- **Statement of Cash Flows**
- **Comprehensive Income Statement**

SOFTBYTE SA
Income Statement
For the Month Ended September 30, 2017

Revenues		
Service revenue		€ 4,700
Expenses		
Salaries and wages expense	€900	
Rent expense	600	
Advertising expense	250	
Utilities expense	200	
Total expenses		1,950
Net income		**€2,750**

1

SOFTBYTE SA
Retained Earnings Statement
For the Month Ended September 30, 2017

Retained earnings, September 1	€ 0
Add: Net income	**2,750**
	2,750
Less: Dividends	1,300
Retained earnings, September 30	**€1,450**

Illustration 1-11
Financial statements and their interrelationships

LO 8

SOFTBYTE SA
Retained Earnings Statement
For the Month Ended September 30, 2017

Retained earnings, September 1		€ 0
Add: Net income		2,750
		2,750
Less: Dividends		1,300
Retained earnings, September 30		€1,450

SOFTBYTE SA
Statement of Financial Position
September 30, 2017

Assets		
Equipment		€ 7,000
Supplies		1,600
Accounts receivable		1,400
Cash		8,050
Total assets		€18,050
Equity and Liabilities		
Equity		
Share capital—ordinary	€15,000	
Retained earnings	1,450	€16,450
Liabilities		
Accounts payable		1,600
Total equity and liabilities		€18,050

1

2

Illustration 1-11

LO 8

SOFTBYTE SA
Statement of Financial Position
September 30, 2017

Assets		
Equipment		€ 7,000
Supplies		1,600
Accounts receivable		1,400
Cash		**8,050**
Total assets		€18,050
Equity and Liabilities		
Equity		
Share capital—ordinary	**€15,000**	
Retained earnings	**1,450**	**€16,450**
Liabilities		
Accounts payable		1,600
Total equity and liabilities		€18,050

Balance sheet and income statement are needed to prepare statement of cash flows.

SOFTBYTE SA
Statement of Cash Flows
For the Month Ended September 30, 2017

Cash flows from operating activities		
Cash receipts from revenues		€ 3,300
Cash payments for expenses		(1,950)
Net cash provided by operating activities		1,350
Cash flows from investing activities		
Purchase of equipment		(7,000)
Cash flows from financing activities		
Sale of ordinary shares	€15,000	
Payment of cash dividends	(1,300)	13,700
Net increase in cash		8,050
Cash at the beginning of the period		0
Cash at the end of the period		**€ 8,050**

2

3

Illustration 1-11
Financial statements and their interrelationships

Income Statement

- Reports the profitability of the company's operations over a specific period of time.
- Lists revenues first, followed by expenses.
- Shows net income (or net loss).
- Does not include investment and dividend transactions between the shareholders and the business.

Financial Statements

Review Question

Net income will result during a time period when:

a. assets exceed liabilities.

b. assets exceed revenues.

c. expenses exceed revenues.

d. revenues exceed expenses.

Retained Earnings Statement

- Reports the changes in retained earnings for a specific period of time.
- The time period is the same as that covered by the income statement.
- Information provided indicates the reasons why retained earnings increased or decreased during the period.

Statement of Financial Position

- Reports the assets, liabilities, and equity at a specific date.
- Lists assets at the top, followed by liabilities and equity.
- Total assets must equal total liabilities and equity.
- Is a snapshot of the company's financial condition at a specific moment in time (usually the month-end or year-end).

Financial Statements

Review Question

The financial statement that reports assets, liabilities, and equity is the:

a. income statement.

b. retained earnings statement.

c. statement of financial position.

d. statement of cash flows.

Statement of Cash Flows

- Information on the cash receipts and payments for a specific period of time.
- Answers the following:
  - Where did cash come from?
  - What was cash used for?
  - What was the change in the cash balance?

HELPFUL HINT
Investing activities pertain to investments made by the company, not investments made by the owners.

Comprehensive Income Statement

- Other comprehensive income items are not part of net income.
- Reported either by
  - Combining with income statement, or
  - Separate statement.

Illustration 1-13
Comprehensive income statement

SOFTBYTE SA
Comprehensive Income Statement
For the Month Ended September 30, 2017

Net income	€2,750
Other comprehensive income	600
Comprehensive income	€3,350

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